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Investment Talks:

China's growth tremors: Risks, opportunities and the road ahead

INVESTMENT TALKS

Vincent MORTIER
Deputy CIO, Asia ex Japan Supervisor

Alessia BERARDI
Deputy Head of Macroeconomic Research

Angelo CORBETTA
Head of Asia Equity

Esther LAW
Portfolio Manager
Emerging Market Debt

With the contribution of:
Debora Delbo'
Senior Strategist
Nicholas McConway
Portfolio Manager China Equity

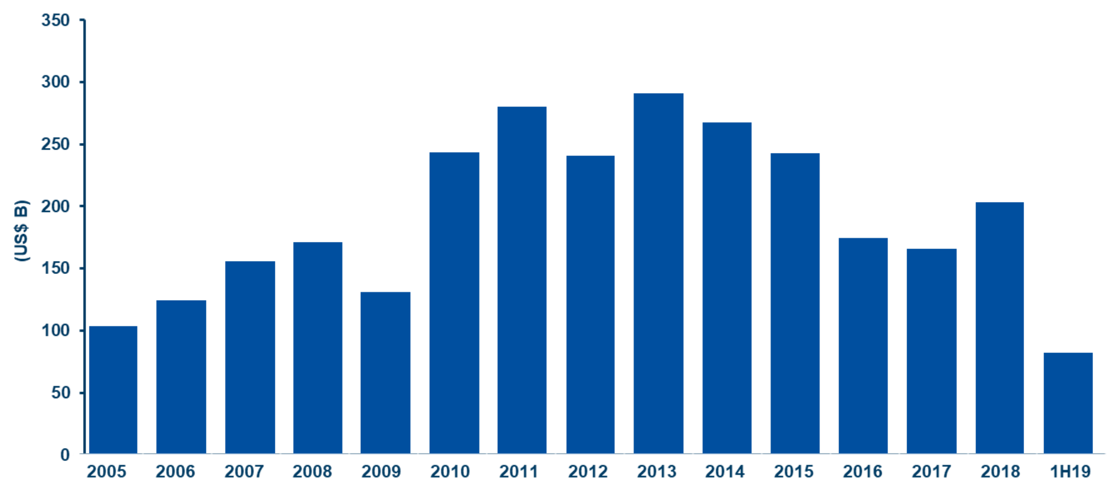
- **Economy:** soft landing and light policy support. In terms of Chinese growth, we see the rate continuing to slow. Chinese GDP growth rose 6.0% in the third quarter of 2019 (Chinese authorities forecasted a range of 6.0%-6.5% YoY), the slowest pace since the early 1990s. Moving into 2020, we do expect that the new growth target will be set around 6.0%, if not lower, at between 5.5% and 6.0%, and our current forecast is confirmed at 5.8% YoY. Exports unsurprisingly have been weak, private capex has slowed notably, and public infrastructure has not picked up as expected. Going forward, we expect public infrastructure capex to accelerate, and the tight real estate policy stance to potentially moderate. Chinese policy mix remains stimulative, though in a very limited way so far and far away from the massive stimulus implemented in recent years.
- **Investment implications:** Overall, we are moderately constructive on the China's equity market. We see valuations as being supportive, though the earnings growth outlook appears muted. We maintain a preference for A-shares equities that are more exposed to the domestic Chinese economy that benefit from the MSCI inclusion process. We also see opportunities in supply chain shifts (Taiwanese and Chinese tech) and in domestic brands offering increasingly more competitive products to international brands.
- **Asia region:** We prefer to be selective and take advantage of the domestic stories that look to be able to deliver some fiscal expansion. We are still constructive on India, although domestic demand remains weak. We like the IT/software sector, where companies enjoy large cash flow yields and the best ones are willing to pay higher dividends.
- **EM fixed income:** We remain slightly positive on EM fixed income. We believe that this environment of still very loose monetary policy globally will continue to favour emerging

markets bonds, including Asian bonds. In Asia, we are particularly positive on Indonesia and China duration.

What is your assessment of economic outlook for China?

The economic outlook for China has deteriorated significantly over this year. China's GDP growth rose 6.0% in third-quarter 2019 (Chinese authorities had forecast a range of 6.0%-6.5% YoY), the slowest pace since the early 1990s, confirming annual average growth at just above 6.0% (6.2% YoY). Moving into 2020, we expect that the new growth target will be set around 6.0%, if not lower, at between 5.5% and 6.0%. Our current forecast is confirmed at 5.8% YoY. The performance of China's economy continues to be at the hearth of the trade dispute with the US and all the measures implemented have acted as a drag on growth. The contribution of net exports has continued to be positive in 2019 as imports have declined much more than exports (hit by tariffs). Indeed, the external shock is occurring along with domestic policies aimed at deleveraging and higher regulation, and these factors continue to be issues while the economy is under threat from external influences. The industrial, consumer and property sectors are all being negatively affected, although to different extents. Fixed assets investments have been struggling in the private and manufacturing sectors much more than in the SOE and infrastructure. September figures show a decoupling between the two sectors. Household consumption, with the exception of auto sales, has decelerated only moderately. Overall, a much stronger slowdown in the economy is likely to be associated with a further escalation in tariffs and extra-tariff measures, and also the lack of any appropriate intervention by the monetary and fiscal authorities, aimed at pursuing more structural objectives. That said, we expect China to compromise more on the growth side to maintain its financial stability, but not to the point of pushing the economy into a hard landing.

China BoP: inward direct investment



Source: Factset, as at 16 October 2019.

"Further accommodation is expected, but should be limited and precisely targeted".

Do you expect to see further accomodation?

China's policy mix continues to focus on stimulation, though so far in a very limited way and far away from the massive stimulus implemented in the recent years. On the monetary policy side, rate cuts have been limited and very much targeted (further cuts in the Reserve Requirement Ratio to come soon) as proven by the September decision by the People's Bank of China to keep the Loan Prime Rate (LPR) on hold. The recently announced LPR reform is causing marginal easing, de facto favouring the big banks and the safest customers (big corporations) without promoting more credit access to the riskiest customers (small enterprises). At the end

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of August, it was clarified that the LPR should be a floor for mortgage rates, preventing any further decrease there and confirming the unwillingness to stimulate the economy through the property market. Credit growth bounced back slightly in October 2018, but has increased only modestly since then, driven by the core components of the RMB loans and the corporate loans. Almost all local governments have used up their annual bond quotas (both special and generic) for this year. The official budget balance deficit has risen well above the target.

"We are moderately constructive on China's equity market. We see opportunities in domestic-exposed companies and supply chain shifts".

What is your view on China's equity market and where do you see opportunities and risks?

Overall, we are moderately constructive on China's equity market. China's government is trying to support the economy with controlled and measured interventions, both on the monetary and fiscal sides. We see valuations as being supportive to the market while earnings growth outlook appears muted (it looks to be priced in).

Further, we see expectations of a partial or temporary cessation as quite likely; however, the barriers to getting a full deal require substantial movement on both sides – i.e., the US acting as a 'compliance watchdog' in a bilateral deal would be unacceptable to China, as would the continuation by the US to blacklist Chinese companies and the current directive to potentially limit US funds investing in Chinese companies. Even considering these dynamics, we see a partial deal or cessation of tariff hikes as probable, as both the US and China are unlikely to want to pay the price of a full-blown escalation. However, we are monitoring the situation closely and still expect to see further volatility in future.

We maintain a preference for A-shares equities that are more exposed to the domestic Chinese economy and which could benefit from MSCI inclusion (on 28 August, MSCI raised the A-share inclusion ratio from 10% to 15%).

We see opportunities in supply chain shifts (Taiwanese and Chinese tech sectors), China's insourcing of components and creation of markets for less good but still satisfactory solutions. We also see the internet sector as becoming more mature, with declining growth rates and maturing market share having led to focus more on profitability and sustainability rather than irrational competition. We see opportunities in the trend of consumer upgrading in China and in domestic brands offering increasingly more competitive products to international brands. Additionally, we see opportunities in education, as demand is relatively inelastic and household spending is growing, with players investing in online delivery that could transform the industry's market share composition.

The risks are quite numerous. The Honk Kong situation is gaining attention and international criticism is rising – something China does not welcome, given this is viewed as a sovereignty issue. A policy mistake here by China, however unlikely, could introduce meaningful risk to China/HK risk premiums.

Finally, clearly, the trade war could escalate, as it appears that the signals continue to be very mixed. Other risks could include over-tightening in the real estate market or failure to support local government fiscal projects.

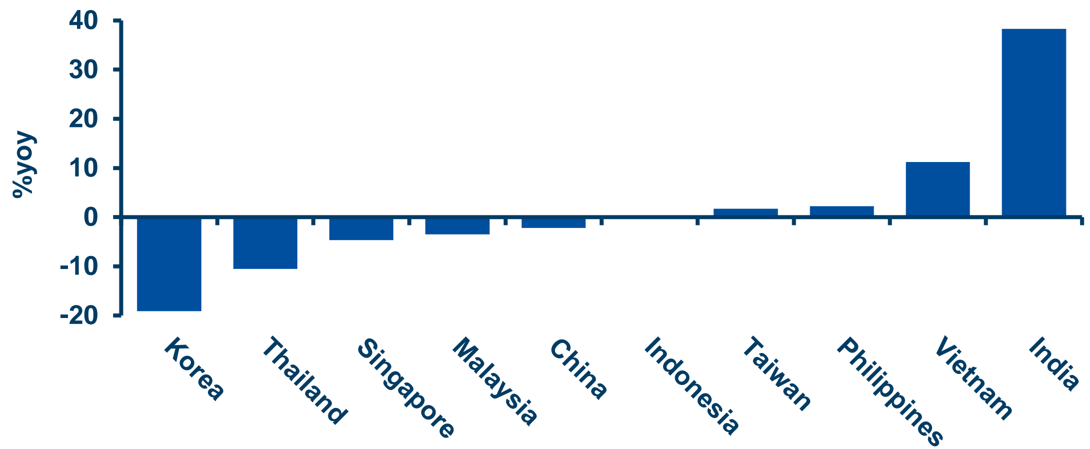
"In Asia, we prefer to be selective and take advantage of domestic stories that can deliver some fiscal expansion".

Looking at Asia overall, which countries/sectors look more interesting for equity investors?

In general, we think that the cycle is a bit mature for the global emerging market equity overall. Economic momentum remains sluggish among the different EM areas – above all, in Asia. EM exports are still negative, though stabilizing. We prefer to be selective and take advantage of domestic stories that can potentially deliver some fiscal expansion. On a one-year horizon, an advanced late cycle favours quality and dividend yield. Other than China, we remain positive on some insulated countries, with enough room to deliver some fiscal expenditure. We are still constructive on India, although domestic demand remains weak. The decision to lower the corporate tax rate signaled the government has now understood how weak the domestic economy is. We still like the IT/software sector, where companies enjoy large cash flow yields and the best ones are willing to pay higher dividends. In the banking sector, we prefer corporate banks, as we believe that non-performing loans have peaked and valuations are now more realistic. On this basis, we think Taiwan is doing very well, mainly driven by the excellent

performance of the technology sector and by the relocation decision implemented by many companies that previously operated in China. As it is often the case, in a weak economic cycle, the technology sector is the first to experience higher inventories, but it is also the first to clear excessive inventories.

Changes in electronics exports in the first six months of 2019



Source: Gavekal Research data, as at 16 October 2019.

What is your view on Asia bonds and, more specifically, China bonds?

We remain slightly positive on EM fixed income. Disappointing macro data suggest that monetary policy stances will remain very accommodative, and in this environment of still very loose monetary policies globally and with about 30% of global bonds showing sub-zero yields, we believe EM bonds, including Asian bonds, will continue to benefit from this external backdrop. In Asia, we are particularly positive on Indonesia and China duration. We like Indonesia based on a benign inflation outlook, further monetary policy easing potential, attractive real yields, and a stable political backdrop.

"We remain slightly positive on EM fixed income, including Asia bonds, as the external backdrop is still supportive. We favour Indonesia and China duration".

We are positive on China bonds, despite the uncertainty surrounding the global trade issue, as we believe they will benefit from increasing investor interest and flows: recent and index inclusion of China government bonds (Bloomberg Barclays Global Aggregate index in April 2019 and JP Local Currency Government Bond index in February 2020) are important steps along the road to opening up the country's capital markets and could bring about USD300bn of flows into the local government bond market. This technical factor, together with the easing bias in China, should support further outperformance by China local bonds.

On the currency front, what are your investment convictions regarding Asian currencies?

We have less conviction on Asian currencies than local-duration and hard-currency sovereign bonds, as EM FX remains the 'shock absorber' to any headline risks. In particular, we are cautious on currencies that are strongly related to trade war disputes, such as the Taiwan dollar and the South Korean won (the US dollar provides positive carry vs the TWD and the KRW). We remain positive on some high-yield currencies in Asia (e.g., the Indonesian rupiah and the Indian rupee).

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